Australian Gold Fund Valuation and SWOT Analysis

St Barbara Mines Limited (ASX: SBM)

Date	6/05/2020
Classification	Mid-Tier Gold Miner
Current Price	$2.500
No. Issued Stocks (m)	703.1
Net Cash + Bullion + 0.5 x GIC ($ m)	-$17.61
Last Dividend Payment ($ p.a.)	$0.08
Market Capitalisation ($ m)	$1,757.74
Enterprise Value ($ m)	$1,775.35
Resources (oz)	12,173,000
Reserves (oz)	6,427,000

Ranking	Fair Value
Price Range	$1.825-$2.97
Annual Gold Production Guidance (oz p.a.)	370 000-400 000
All-In Sustaining Cost Guidance ($/oz)	$1 330-$1 420
EV/AISC-Adjusted Production Guidance ($/oz)	$6,341.00
EV/AISC-Adjusted Production Range ($/oz)	$5 000-$7 000
EV/Resources ($/oz)	$145.84
EV/Reserves ($/oz)	$276.23

Summary

St Barbara Mines released their March quarterly report on 28th April 2020. The company has had a rather underwhelming year after making an announcement regarding the cost blowout regarding the Gwalia Mine Extension Project. The stock price fell from its all-time high in late February 2019 and prevailed in the $2.50-$4.00 range for much of the period. The company was not immune to the market crash in late February 2020 to late March 2020 resulting from the fears over the coronavirus pandemic that led to many countries imposing restrictions on movement and business operations. At its minimum, the stock traded at $1.615 and is currently trading at $2.50 at the time of writing (the stock closed today at $2.53), valuing the company at around $1.76 billion.

For the March 2020 quarter, the company produced 91 547oz at AISC of $1 396/oz and this brings the cumulative production for the 2020 financial year to 273 275oz at AISC of $1 393/oz. The company generated around $76m of net operating cashflows net of maintenance capital expenditure, a rather strong performance. The cash balance increased from $79.2m to $320m, but this is due to a $200m drawing down of the existing credit line. The net debt position fell from $58.5m to $17.6m during the quarter. This was a rather impressive performance given around $18m of dividends being paid. However, on the operational side, things are not as impressive. The Gwalia mine produced marginally more gold, at 39 684oz, than in the September 2019 quarter (38 153oz) and the AISC is above $1 550/oz. The Simberi mine produced more gold, at 25 831oz, than the December 2019 quarter (23 070oz) but less than the September 2019 quarter (27 061oz), with AISC above $1 600/oz. Atlantic Gold produced less gold, at 26 032oz, than the December 2019 quarter (29 067oz) and more than in the September 2019 quarter (22 355oz) with AISC at $951/oz. The company expects to deliver a stronger June quarter to round off the year where its guidance is 370 000-400 000oz at AISC $1 330-$1 420/oz. This requires next quarter's production to exceed 100 000oz. We hold the view that this is not likely given the potential restrictions still in place from the winding down of the coronavirus pandemic.

The company also saw the previous CEO Bob Vassie step down effective early February, with Craig Jett stepped up to replace him. Craig has a background in working in Newcrest with experience in the Cadia and Lihir mines. This appointment bodes positively for the next stage of the company's plans as it seeks to focus its efforts on the Simberi Sulfide development project, which has now completed a pre-feasibility study as at early May. This project is expected to cost around US$130m-$150m (A$200m-$240m) to produce around 1.8Moz of gold over 13 years at AISC of around US$920/oz (A$1 470/oz). This study is a marked improvement to that implemented in 2016, which may have been a reason why the company deferred its development until now given they wanted to commit their capital elsewhere. Furthermore, the Simberi mine is clearly running down its oxide ore and thus the transition towards mining the sulfide ore is warranted.

Looking back at last year's acquisition of Atlantic Gold in mid-May, we still affirm the view that while the acquisition refreshes the company's operations and brings in well-needed operating cashflows in

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light of declining production levels and ore grades. Without Atlantic Gold, they would be producing at around 260-300koz for the year, which would be some 25-30% less than their 5-year historical average. To the merit of the management for their foresight in making the acquisition, this was necessary to ensure that they would be able to fund their development going forward with operating cashflows. However, we are of the opinion that the company's acquisition of Atlantic Gold was substantially overvalued on all fronts – AISC-adjusted production, reserves and resources. While Atlantic Gold is a low-cost mining company, the price paid wiped out the very substantial cash reserves the company had accumulated since Vassie took the helm, and even left the company in a slightly net debt position after having diluted the company's shareholdings by 33%. Given the many acquisitions of companies and mines in the past 12 months in this space, we are quite convinced that this acquisition was the most expensive.

In terms of the company's future prospects, we believe that the company needs to prove to the investors that the Gwalia Mine Extension project will deliver higher grade ore and increase their production within the next two quarters. If the Gwalia mine does not return to producing more than 200 000oz p.a., this will weaken the company fundamentally given this mine is their flagship and they still have some 2Moz of reserves in their books. The Simberi mine should likely continue its current performance and provide the company with upside potential in generating operating cashflow due to its unhedged position. As for Atlantic Gold, production is expected to improve for the next two quarters due to more favourable weather conditions coming out of winter. In terms of the company's exposure to the expected rise in the gold price, around 35% of their June quarter production is hedged at less than A$2 000/oz while around 25-30% of the 2021 production is hedged also at prices below A$2 000/oz. This is not optimal but it is the nature of insurance contracts, and not many saw it coming that the gold price would rise so quickly in the last 12 months even though all signs pointed to this being imminent.

At the current stock price of $2.50 implying an enterprise value of around $1.775 billion, the company's trading at an EV/AISC-Adjusted Production of around $6 340/oz when taking into account the 2020 production guidance. Taking into account the company's mine operations being based largely in secure jurisdictions of Australia and Canada, with Papua New Guinea being moderately secure, the company's strong liquidity position with little pressure from near-term liabilities and the company's potential growth prospects, we believe that the fair valuation range would be $5 000-$7 000/oz, a slight premium for mid-tier companies. St Barbara boasts substantial reserves and resources that are expected to allow for mine lives exceeding 10 years, albeit that the company needs to commit a not insignificant level of capital to develop and maintain their production. Given this, we believe the company is trading in the upper end of their fair valuation range.

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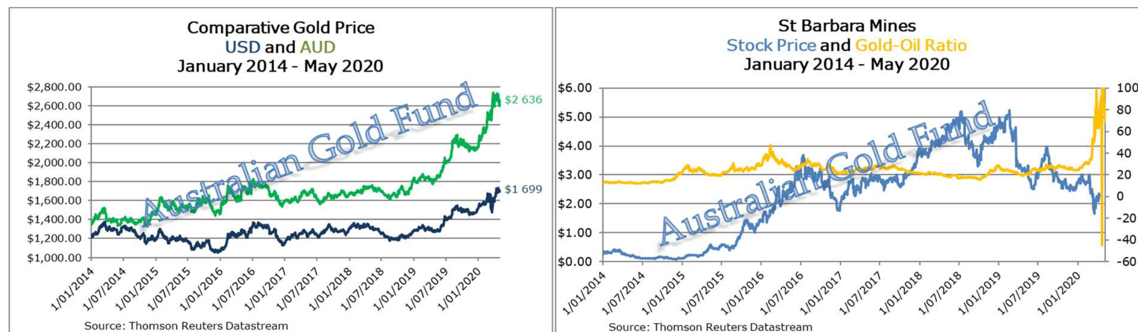
Prevailing Environment



The recent four months have seen the world and the global financial markets face some monumental events that have made a lasting impact, and will expect to steer the world in a different trajectory hereafter. A combination of events starting with the US-Iranian conflict (who still remembered this?) in early January, the spreading of the coronavirus leading to a pandemic starting late last year, the collapse of OPEC talks in early March and then the sharp global market crash from late February to March have shaken nations, corporations and households alike. In the midst of this, most market indices around the world declined 25-40%, most commodity prices fell (except for gold) and so did cryptocurrencies (though some have bounced to back and more). The Federal Reserve cut their interest rate to 0-0.25% by mid-March, bringing them back to late-2008 at the onset of the subprime crisis. In addition, the Federal Reserve Board of Governors has indicated that they will have almost unlimited capacity to create currency to monetise debt in the bid to prevent the economies and markets from imploding. Other central banks have followed while the Reserve Bank of Australia has cut rates to 0.25%. Governments have announced stimulus packages and foreshadowing tax cuts to aid small businesses and households facing national lockdowns that have brought many cities to a standstill.

In the midst of all this, the gold price has seen a steady rise during this period with a short yet violent decline for a few days in March when it went below US$1 500/oz. However, gold demonstrated its safe haven status, laying claim to being one of very few assets that saw its price stand strong during the market-wide sell-off. The gold price started the year at US$1 520/oz and traded during this period in the US$1 460-$1 750/oz range. In Australian dollar terms, gold has broken out on the upside, starting the year at A$2 163/oz and peaking at over A$2 800/oz as the Australian dollar dipped to as low as US$0.56.

The oil price has also seen a historic crash from US$64/bbl in early January in the wake of the drone strike by the US that killed the Iranian Revolutionary Guard Commander Qassim Soleimani to US$16.60/bbl in late March in the aftermath of OPEC facing potential breakdown after negotiations between Saudi Arabia and Russia on production targets failed on 6th March. However, that was not to be the minimum as the spot price for WTI crude oil fell to -$37.63/bbl on 20th April, something that has not been seen in history or can even be imagined (2020 is a year where at one stage a pack of toilet paper is cheaper than a barrel of oil, go figure!). The gold-oil ratio exceeded 100 and is currently at 69. With many countries beginning to relax their lockdown restrictions from this point on, we expect economic recovery to be gradual but demand will likely to be slow for some time. This could lead to the demand for oil to continue to be tepid and the oil price to remain low. This should provide substantial tailwinds for mining companies and industries that are still running given input costs should be lower for a short while.

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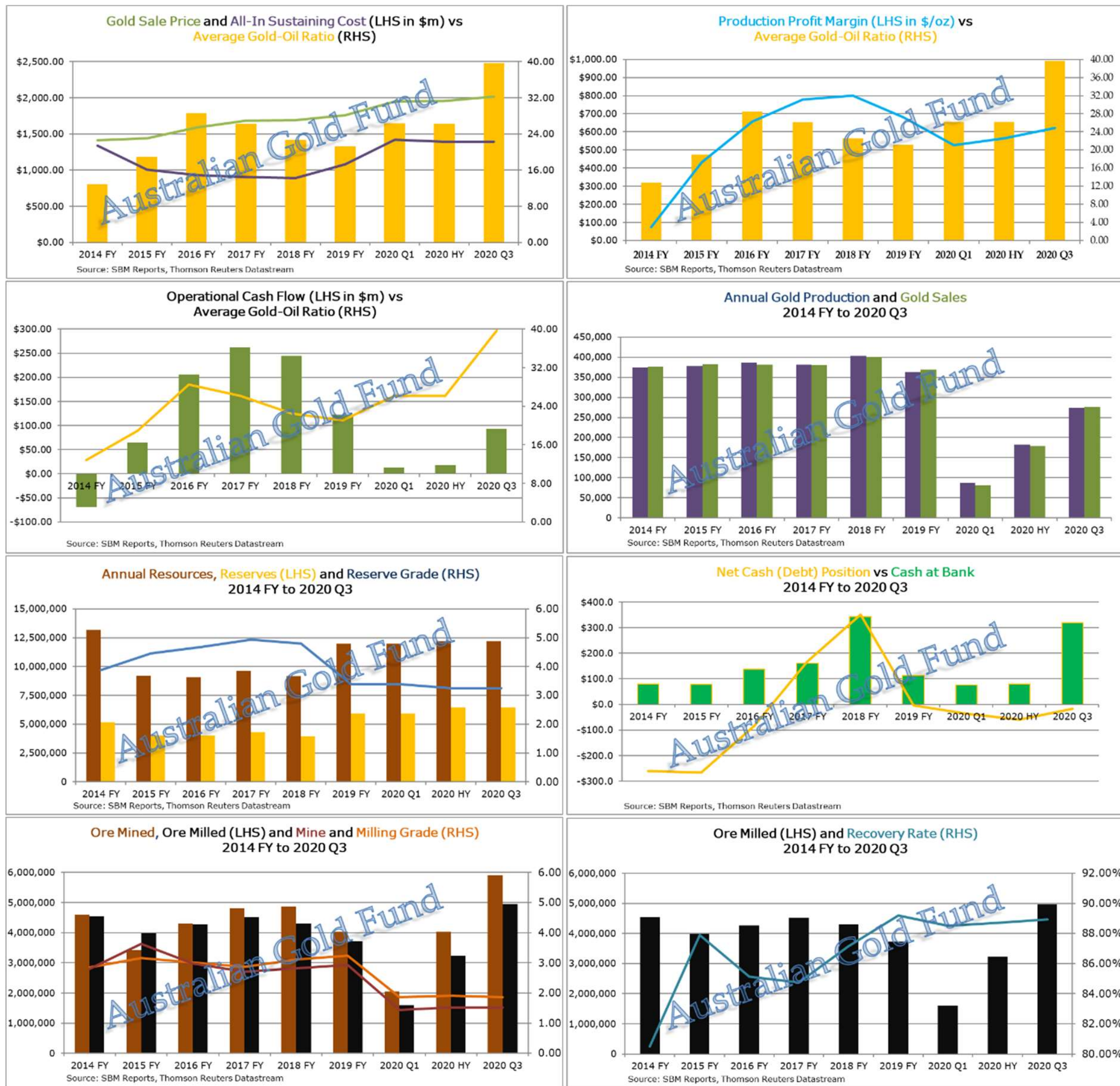
Operational and Financial Performance Charts



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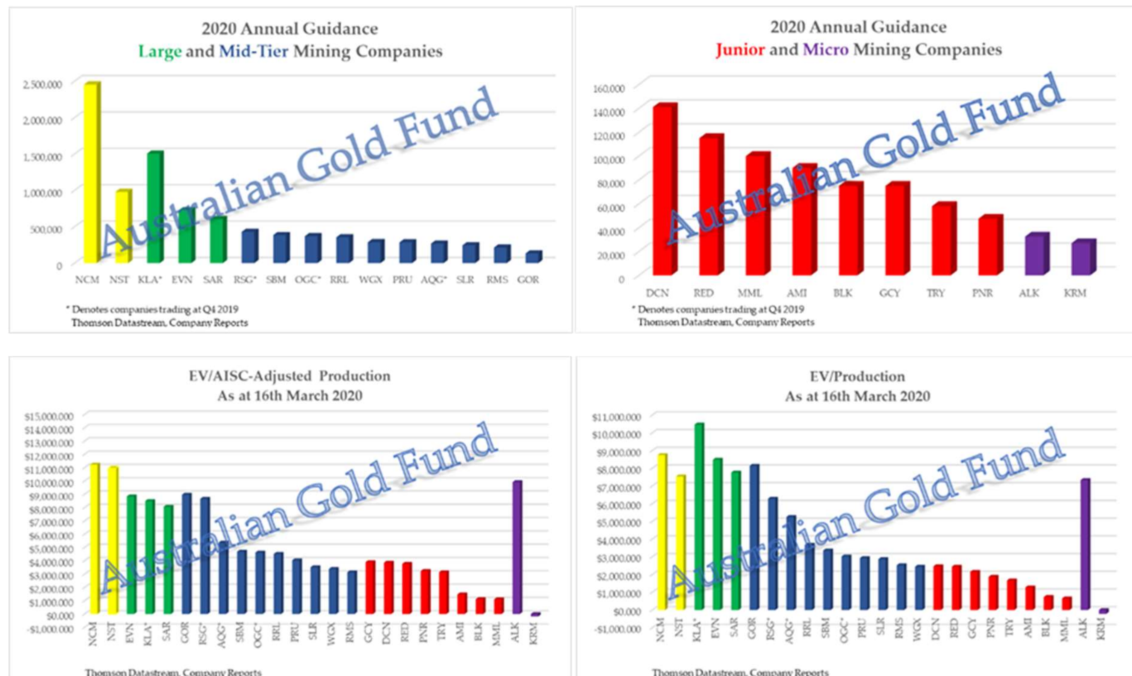
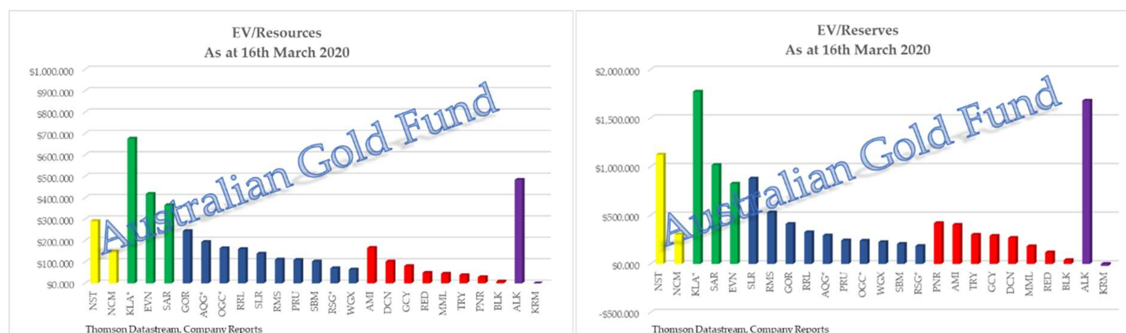
SWOT Analysis

Strengths	Weaknesses
• Diversified operations with over 70% of production sourced from very secure jurisdictions. • Operations are able to generate significant free cashflows to support future development and a steady dividend stream. • Substantial reserves and resources base allowing for mine-lives exceeding 10 years.	• Existing mine production have been declining markedly with significant jump in AISC. • Development of mines in recent history has drained substantial cash without apparent delivery of benefits.
Opportunities	**Threats**
• Substantial cash balance may be used to fund acquisitions of explorer companies in close proximity to expand resources base or even allow for immediate increase of production in existing mines. • Development of the Simberi Sulfide Project will lead to substantial extension of the Simberi mine.	• Declining operations may lead to reserve write-down especially in the Gwalia mine, especially if the extension project does not lead to turnaround in operations. • Supply chain bottlenecks due to delays after the lifting of global lockdown restrictions could lead to AISC increase and lower operating cashflows.

Peer Comparison





Valuation Thesis

The gold mining companies are classified based on their production level on an annual basis. The classification used in this report is as follows – **A** (major producer – 1Moz p.a. or more), **B** (large producer – 0.5-1Moz p.a.), **C** (mid-tier producer – 150 000-500 000oz p.a.), **D** (junior producer – 50 000-150 000oz p.a.) and **E** (micro producer – less than 50 000oz p.a.).

We use the **EV/AISC-Adjusted Annual Production** as a *comparative measure* to evaluate the companies we study. This metric is able to standardise the production and production costs and hence allow for comparison across all classes of producers. The **Enterprise Value** is the sum of the market value of equity (stock price multiplied by number of issued stocks) and net debt (total borrowings less cash and gold bullion, but excluding gold in circuit and ore stockpiles). The **AISC-Adjusted Annual Production** is measure whereby the annual production of gold per oz is divided by the AISC adjusted by a factor of 1 000. The intuition behind this measure is to value the company by taking into account annual production but giving favourable treatment for lower AISC and penalising for higher AISC. The factor of 1 000 is arbitrarily chosen. As an illustration, if a company produces 250 000oz p.a. at AISC of $1 250, the AISC-adjusted production is 200 000.

The **Price Range** determines a reasonable range for which the company stock price should be trading at. This range is relatively wide as it considers the *margin of safety*. A company whose stock price is currently outside the fair value range is significantly over or undervalued and investors should look more deeply into the company's operations, financial performance and recent market announcements. This range should not be taken as the sole driver for investment decisions, but as a starting point for further research to identify the potential causes for the current stock price.

Given the rise in gold price in the recent three months, we see reason to re-rate the gold mining companies' valuation metrics upwards to reflect their improving profitability as well as increased enthusiasm from investors. As a rough guide, the fair value ranges for different mining company classes are as follows:

Major and Large Companies *- $8 000-$12 000/oz*

Mid-Tier Companies *- $4 000-$7 000/oz*

Micro and Junior Companies *- $1 500-$4 000/oz*

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The metric is by no means perfect and other factors should be considered including reserve and resource life, projected production volume and costs, management quality and geographic location. Further, it is of a retrospective nature, focusing on past performance and this may not be a good indicator for future performance.

Glossary

The **All-in Sustaining Cost (AISC)** is a measure adopted by the World Gold Council as a standardised measure of production costs. This cost includes typically the **Cash Cost** associated with the direct production (extraction, transportation, processing and refining costs, staff salary and wages and relevant corporate costs) as well as **Sustaining Expenditure** that may include maintenance of mine equipment and infrastructure, insurance and administration costs over its production life. Companies may still have discretion in apportioning their expenses.

The **Net Cash/Debt** is the net amount of cash and bullion the company holds after their borrowings and interest-bearing debt are paid. This represents the liquidity position of the company, although this measure does not consider whether the debt is current (due within the next twelve months) or not. A company in a significant net debt position is owing more than they currently have in cash and bullion, which may potentially put them in financial distress if the debt is due soon.

The **Net Cashflow from Operations Excluding Maintenance Capital Expenditure** measures to what extent the company can generate cashflows from its operations after paying for its operating costs as well as Cash Paid for Purchases of Property, Plant and Equipment and the Cash Paid for Development Expenditure in the Investing Cashflows section of the Statement of Cash Flows. It does not include Cash Paid for Exploration and Evaluation, which is assumed to be growth capital expenditure. This is by no means a stable and comparable measure as different companies may have discretionary interpretation of what constitutes as Operating Activities and Investing Activities or Development, Exploration and Evaluation expenditures.

Disclaimer

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Declaration of Interest

The Australian Gold Fund and its directors currently own St Barbara stocks and may trade them subsequent to the report being published on their website. We do not receive any income or benefits from the company as a result of our report.